COMMENTS

of

WASHINGTON LEGAL FOUNDATION

on the

FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE U.S. SECURITIES AND EXCHANGE COMMISSION FILE NO. 265-23

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April 3, 2006

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via email
Nancy M. Morris
Federal Advisory Committee Management Officer
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File Number 265-23: Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission

Dear Ms. Morris:

The Washington Legal Foundation (WLF) hereby submits these comments on the Exposure Draft of the Final Report published by the Securities and Exchange Commission Advisory Committee on Smaller Public Companies (Draft Report). In brief, WLF supports easing the burden of complying with Section 404 of the Sarbanes-Oxley Act for smaller public companies. In that regard, WLF supports the Committee's Recommendation II.P.1 establishing a scaled or proportional securities regulation for smaller public companies, and the corresponding relief under Sarbanes-Oxley as recommended, including allowing smaller public companies to follow the financial statements rules now followed by small business issuers, as more further described in Part III and Part IV of the Draft Report.

I. **Interests of WLF**

WLF is a nonprofit, public interest law and policy center based in Washington, D.C., with supporters nationwide. Since its founding 29 years ago, WLF has advocated free-enterprise principles, responsible government, property rights, a strong national security and defense, and a balanced civil and criminal justice system, all through WLF's Litigation Department, Legal Studies Division, and Civic Communications Program.

WLF is filing these comments as part of its INVESTOR PROTECTION PROGRAM. The goals of WLF's INVESTOR PROTECTION PROGRAM are comprehensive: to protect the stock markets from manipulation; to protect employees, consumers, pensioners, and investors from stock losses caused by abusive litigation practices; to encourage congressional and regulatory oversight of the conduct of the plaintiffs' bar with the securities industry; and to restore investor confidence in the financial markets through regulatory and judicial reform measures. Additional information about WLF's INVESTOR PROTECTION PROGRAM is available on our website at *www.wlf.org*.

As part of WLF's INVESTOR PROTECTION PROGRAM, WLF has filed several complaints with the SEC requesting formal investigation of several instances where there appeared to be a manipulation of the price of the stock by short sellers who were collaborating with class action attorneys. At least in one of those cases involving *In re: Terayon Communications System, Inc.*, the SEC did conduct an investigation, although it is not certain whether the case is still open.

From time to time, WLF also files comments with the SEC on various matters of interest. For example, on January 26, 2006, WLF filed comments on SEC Release No. 53025 (Dec. 27, 2005) regarding the distribution of moneys placed into seven Fair Funds as a result of a settlement by the SEC with seven New York Stock Exchange specialist firms. On April 30, 2003, WLF filed comments with the SEC in response to request for public comments on the two-day Hedge Fund Roundtable. In those comments, WLF requested that the SEC's investigation of hedge funds include the issue of the relationship between plaintiffs' attorneys and short sellers. WLF was also invited to testify before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services of the U.S. House of Representatives in May 22, 2003, on "The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: The Relationship Between Short Sellers and Trial Attorneys."

WLF also appears before federal courts in cases as amicus curiae involving securities litigation. *See, e.g.*, *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005); *Merrill Lynch v. Dabit*, 2006 U.S. LEXIS 2497.

WLF's Legal Studies Division has produced and distributed timely publications on securities regulations. WLF's recently published Legal Backgrounders on the topic include: Bob Merritt, *The Sarbanes-Oxley Act: A Personal View* (WLF Legal Opinion Letter, Oct. 21, 2005) (copy attached); Peter L. Welsh, *Sarbanes-Oxley And The Cost Of Criminalization* (WLF Legal Backgrounder, Aug. 30, 2002); Robert A. McTamaney, *The Sarbanes-Oxley Act Of 2002: Will It Prevent Future "Enrons"?* (WLF Legal Backgrounder, Aug. 9, 2002).

II. WLF Comments on Draft Report

It is undisputed that the cost of complying with Section 404 of Sarbanes-Oxley has been extremely costly and burdensome. These staggering compliance costs are particularly prohibitive for smaller public companies, such as new companies in the high-tech area, including biotechnology companies. Those costs are passed on to the investors without a corresponding benefit. The SEC sought to address these concerns by establishing the Advisory Committee on Smaller Public Companies on March 23, 2005, and which is scheduled to terminate on April 23, 2006.

The Committee's Charter directs its to further the SEC's investor protection mandate as well as determine whether the costs imposed by the current regulatory system for smaller companies outweighs the benefits. To that end, the Committee has held hearings, received thousands of comments, and produced a draft report in February 2006 that is 139 pages in length, not including numerous appendices. Comments have been received from smaller companies, associations, investors, accountants, lawyers, and other interested persons. WLF has reviewed a sampling of those comments and submit that they overwhelmingly support our belief that Section 404 is unduly burdensome for smaller companies; therefore, the Committee's recommendation to ease the regulatory burden for those companies should be adopted.

Recommendation II.P.1. The Advisory Committee recommends the following:

> **Establish a new system of scaled or proportional securities regulation for smaller public companies using the following six determinants to define a "smaller public company":**
> *** the total market capitalization of the company;**
> *** a measurement metric that facilitates scaling of regulation;**
> *** a measurement metric that is self-calibrating;**
> *** a standardized measurement and methodology for computing market capitalization;**
> *** a date for determining total market capitalization; and**
> *** clear and firm transition rules, *i.e.*, small to large and large to small.**
>
> **Develop a specific scaled or proportional regulation for companies under the system if they qualify as "microcap companies" because their equity market capitalization places them in the lowest 1% of total U.S. equity market capitalization or as "smallcap companies" because their equity market capitalization places them in the next lowest 1% to 5% of total U.S. equity market capitalization, with the result that all companies comprising the lowest 6% would be considered for scaled or proportional regulation.**

Draft Report at 12-13. Thus, the Committee divides smaller companies into two sub-categories, "microcap" and "smallcap" companies. Currently, companies whose common stock fit the category of "microcap" have an equity capitalization below approximately $128 million. Those fitting the "smallcap" category have an equity capitalization between $128 million and $787 million. While the Committee debated making distinctions based on the public float of the stock instead of equity market capitalization, we believe that the equity capitalization definition is appropriate, although the size of revenues may be a better measure for compliance inasmuch as many small companies such as those in the biotech field could have capitalization of $800 million (and thus, not be considered a smallcap under the proposed definition) and yet have little or no revenues.

We are also generally supportive of Recommendation III.P.2 which would provide exemptive relief from external auditor involvement in the Section 404 process for certain smallcap companies with revenues less than $250 million. This recommendation appears to recognize that while companies may seem large in size based on capitalization, their revenues may be small, and hence, Section 404 compliance costs would be more burdensome.

The thousands of comments filed with the Committee are generally supportive of providing much needed relief to smaller companies. One of the many comments submitted by an investor epitomizes the frustration with *Sarbanes-Oxley* as follows:

> As a long-time investor in small companies I have seen very little benefit from SOX 404. I have seen small companies in which I am a stockholder spend RIDICULOUS amounts of MY MONEY trying to comply with legislation that is total overkill. The managements of small companies are wasting way too much of their time trying to comply with SOX 404--this time would be much better spent running their businesses. I can personally attest to the UTTER FRUSTRATION with SOX--I have attended approximately 35 annual stockholder meetings of small public companies, and there is almost universal disgust at the effects of SOX--by managements, stockholders, Board of Directors, etc.

Comment posted on SEC website with respect to Question 1: 08/02/2005 14:31:32.

In addition to that typical comment, WLF also supports the comment recently filed on March 15, 2006 by the International Association of Small Broker-Dealers and Advisors submitted by Peter J. Chepucavage, General Counsel, Plexus Consulting. Mr. Chepucavage correctly sounds the alarm that the Sarbanes-Oxley burden on small companies has reached a crisis state that the Commission, even before it considers the Committee's recommendations, should extend exemption of Section 404 to smaller companies as a temporary measure. Otherwise, "it may kill a whole generation of aspiring startups without any evidence of their history of accounting fraud."

WLF urges both the Committee and the Commission to do all in its power to ensure that smaller companies are provided the much needed relief from the costly and burdensome requirements of Sarbanes-Oxley.

CONCLUSION

For the foregoing reasons and those provided by smaller public companies in their comments, WLF supports the Committee's recommendations that would relieve smaller public companies with the regulatory burden of Section 404 of Sarbanes-Oxley.

Sincerely yours,

Daniel J. Popeo
Chairman & General Counsel

Paul D. Kamenar
Senior Executive Counsel

encl: Bob Merritt, *The Sarbanes-Oxley Act: A Personal View* (WLF Legal Opinion Letter, Oct. 21, 2005)

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THE SARBANES-OXLEY ACT: A PERSONAL VIEW

by
Bob Merritt

During an otherwise routine quarterly conference call with analysts last spring, I announced my resignation as Chief Financial Officer of Outback Steakhouse, Inc., explaining my discontent with the increasingly negative regulatory environment in which public companies operate. I have received countless notes and emails from my peers and from CFOs of other public companies thanking me for publicly stating what they all feel privately. Much has already been written about the direct financial cost of complying with the Sarbanes-Oxley Act, but what of the hidden costs of the Act? It is hard to find fault with the Act's intent, but are the benefits worth the price being paid?

One of the unintended consequences of Sarbanes-Oxley is that financial executives are actually becoming *less* involved, not more involved, in business decision-making. This is partly the result of the burden that the Act places on a CFO's time: CFOs are now forced to spend their days focusing on the formalities of compliance and not on the substance of important business developments that may improve shareholder value. In addition to time constraints, the decline in the business role of the financial executive is the result of a decline in the trust levels between financial and operational executives. To a non-financial executive, none of today's form-over-substance mania makes any sense. In my own experience, the relationship I had with my CEO became strained to the point of his distrust of me and my loyalty; it seemed that each week I had to deliver more news about what we had to do that was different from what we had been doing for thirty years and I couldn't explain how it made any sense. He viewed it as not meeting a common-sense standard and therefore concluded that I had not fought it hard enough. These kinds of strained relationships will lead to the curtailment or elimination of financial executives' influence in business deliberations, to the detriment of shareholders.

The burdens on companies and financial executives have been made worse by one of the Act's creations, the Public Company Accounting Oversight Board (PCAOB). This under-supervised and overzealous group of bean counters has generated countless regulations and has taken a gun-and-badge attitude toward public company managements, their financial executives, and their auditors. PCAOB seems to be operating under a presumption that financial statements are always "right" or "wrong" based upon a set of complex rules, rather than "presented fairly in all material respects." No serious professional involved in any aspect of generating or using financial statements believes that the numbers are exact, with one and only one correct answer. With the possible exception of cash balances, every number in a set of financial statements is an *estimate*. Despite the fact that the last sentence of every accounting standard ever written that says "these standards need not be applied to immaterial amounts," PCAOB continues to generate standards for auditors that presume an unrealistic level of exactness. This is a presumption that will ultimately lead to greater misunderstandings by the users of financial statements.

I find it ironic that a heavily rules-oriented approach is the path the regulators have chosen, since it was the abusive manipulation of rules that allowed Enron to do what it did. I have not heard one person say that Enron's financial statements were not prepared in accordance with Generally Accepted Accounting Practices as the rules existed and I have not heard of any legal charges to that effect. Enron merely used the detailed rules to their benefit. I maintain that if principles-based accounting standards had been in place rather than a detailed set of rules that could be manipulated, the Enron fiasco might have been avoided.

No set of rules can contemplate every possibility. Once the rules are in place, smart lawyers, accountants, and investment bankers can find ways to make the form of a transaction fit the rules while abusing those rules in substance. I am convinced that if regulators continue down their present course we will have more spectacular failures.

The strong arm of PCAOB has emerged as something akin to a "revenge of the nerds." With the reorganization of accounting firms into silos of authority, the authority and judgment of the practice partners closest to the actual companies and their transactions has been all but eliminated. Academics sitting in their ivory towers now seem to have all of the power. These are the people who were ignored for years because the application of their theories did not result in a material improvement in the financial reporting of public companies. Once, financial reporting decisions were judged based upon whether or not they enhanced financial statement users' understanding of a company's results of operation and financial condition. Now, the nerds get to decide what is "right" based upon their interpretation of the rules, whether or not the outcome enhances the usability of the statements.

The nerds are also going back and reinterpreting rules. New interpretations are being issued frequently. A classic example of this was the recent spate of restatements generated by a change in the interpretation of the consistency between two rules that govern the reporting of lease expenses. No new rules had been issued but an academic in one of the large accounting firms decided that there was an inconsistency between the measurement periods used under two different rules and that they should be consistent. Without running this past the accounting rule makers, the firm forced its clients to restate historical financial results. In response, the other large accounting firms evaluated their positions and decided that the first firm was right, but they had forgotten a couple of other components of lease accounting. Then, hysteria ensued and almost 150 companies were forced to restate historical results. None of this enhanced financial statement users' understanding of the results of operation and financial condition of the companies. But because the first accounting firm had failed to take certain conditions into account, some companies actually had to restate their results twice. In addition, there is now an inconsistency between how retailers report rent expense based upon which measurement period and policy they chose. How is this helpful to financial statement users?

But that is not the end of the story. The auditors then started thinking about PCAOB's standards of internal control weaknesses for Section 404 certification purposes. Under the rules, any restatement was evidence of a material internal control weakness. In PCAOB's defense, they do suggest that the auditor look at the circumstances for the implied rare exception. But in this environment, would you as the auditor want to conclude that an exception had arisen? In today's world, who wants to take that risk? No, it is much safer to make the company admit to a material weakness than to apply judgment. Does anyone really care that it is ridiculous that 150 companies might have a weakness that has been in place for 35 years and missed by the auditors for all of those years? No, the accounting firms are running in such fear of PCAOB that they would rather concede the implied incompetence of 35 years of audits than take the risk that there might be an exception to the rather severe rule.

In the final analysis, the environment created by the Act and its implementation have resulted in a misallocation of management's time and attention from real shareholder value creation to regulatory risk avoidance that will not improve the chances of avoiding future public company abuses and failures. In the end, I concluded that the personal risk/reward relationship for me was out of balance and that the strain experienced by our financial management team on their personal lives and relationships with non-financial managers was not worth continuing with a public company. I know of no seasoned public company CFO who has not thought of making a career change at this point.